- o The marginal tax bracket of investors in new issues of tax-exempt securities is 30 percent;[5] and

- o By 1986, IRB sales will have grown by an average rate of 10 percent a year. IRB sales could rise more sharply after 1981, however. An average annual growth rate after 1981 of

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5. This assumption rests on the view that tax-exempt financing ultimately displaces taxable financing. New issues of tax-exempt securities have a domino effect that causes some investors to move from partially taxable to tax-exempt investments and others from fully taxable to partially taxable holdings. In determining revenue losses, the significant measure is the net change in all portfolio holdings resulting from tax-exempt bond issues. Accordingly, the relevant marginal tax bracket is a combination of the tax rates of the last investor who switches from partially taxable to tax-exempt holdings and the investor who moves from fully taxed to partially taxed holdings. This combined tax rate roughly corresponds to the spread between tax-exempt and taxable interest rates, which historically has averaged 30 percent. (In contrast, the average marginal tax bracket of all holders of tax-exempt securities is closer to 40 percent. The lower rate serves to isolate the effects on revenues of a fairly small increment of the stock of tax-exempt debt outstanding. Conversely, for measuring the revenue loss from the entire stock of outstanding tax-exempt bonds, the higher rate is more appropriate.)

   Methods of measuring revenue losses vary and are controversial. See CBO, <u>Tax-Exempt Bonds for Single-Family Housing</u> (April 1979); Roger Kormendi and Thomas Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds" (unpublished paper, University of Chicago Graduate School of Business, July 26, 1979); George E. Peterson and Harvey Galper, "Tax-Exempt Financing of Private Industry's Pollution Control Investment," <u>Public Policy</u> (Winter 1975); Harvey Galper and Eric Toder, "Modelling Revenue and Allocation Effects of the Use of Tax-Exempt Bonds for Private Purposes," U.S. Treasury, Office of Tax Analysis Paper 44 (December 1980); Patric Hendershott, "Mortgage Revenue Bonds: Tax-Exemption with a Vengeance" (National Bureau of Economic Research, Working Paper no. 447, February 1980).

40 percent--which would be roughly equivalent to the performance of IRB sales between 1975 and 1978--would result in new issues in calendar year 1986 of $49 billion and revenue losses in fiscal year 1986 of $4.4 billion.

Revenue Gains from Eliminating Small Issue IRBs

These revenue loss estimates measure the cost to the federal government of continuing the exemption for small issue IRBs. If the exemption for small issue IRBs were ended, the net revenue gain to the federal government would be less than the budgetary cost, since reflow or feedback effects would offset part of the revenue gain.[6] The same is true with any tax increase or any spending reduction. These reflow or feedback effects are normally not calculated separately for each tax and spending change, but instead are taken into account in considering the budget as a whole. This is so for two reasons. First, the precise reflow effects from any particular tax or spending change are very difficult to calculate, since the underlying changes in investment and other economic behavior are hard to forecast. Second, available evidence suggests that variations in the reflow effects from different kinds of tax and spending changes are small. If most tax and spending changes have similar reflows, it would make sense to wait until the full budget is put together before taking them into account.[7]

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6. Federal tax increases or spending reductions reduce economic activity, which in turn reduces tax collections and increases spending for unemployment compensation, food stamps, public assistance and other programs. These reflow or feedback effects partially offset the direct budgetary effects of tax and spending changes.

7. On occasion, the CBO has made a special effort to calculate reflow or feedback effects from changes in spending programs; the CETA public service employment program is one example. CBO's preliminary estimates indicate that eliminating public service employment (PSE) would increase federal spending for public assistance and food stamps by 3 to 5 percent of the PSE cost, and that federal taxes would decrease by about 6 to 10 percent of the total PSE cost. Unemployment insurance outlays would also increase, but no precise estimate of that is available yet. CBO, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981), pp. A-49-50.

In light of the controversy that has surrounded estimates of the revenue losses from tax-exempt bonds, CBO has prepared a special estimate of the reflow effects that would result from eliminating small issue IRBs. It is discussed in the next section on investment and reflow effects.

There is one possible offset to the CBO revenue loss estimates that is partly separate from the reflows issue. The firms that are paying lower interest rates as a result of IRB financing may end up with higher taxable incomes, since their costs of doing business would be less. If so, they would pay higher federal taxes, and the federal revenue losses from IRBs would be offset to that extent. If the firms pass their interest savings on to their customers in the form of lower prices, however, the firms would not have higher taxable incomes and there would be no basis for an offset. The extent to which firms pass on their interest savings in the form of lower prices depends on the degree of competition in the relevant markets, which is almost impossible to estimate.

A further difficulty is that this particular offset only applies to the portion of IRB financing that substitutes for taxable financing that would otherwise occur. The effects on taxable incomes from net increases in investment would show up in the reflow estimates discussed below. Thus, the higher the reflows, the lower this offset would be. Because of the uncertainties involved in estimating this offset, it is not included in the CBO revenue loss estimate.

Aggregate Investment and Revenue Reflow Effects

Small issue IRB sales may stimulate increases in the overall level of investment, which in turn may increase taxable incomes. Although this effect is not relevant when measuring the revenue loss to the federal government from IRBs, it is important when estimating the potential net revenue gain from their elimination. The revenue gain from elimination is partially offset by the lower tax collections that result when the investment stimulus effects of IRBs are withdrawn.

These offsetting reflow effects would occur in the case of any increase in business taxes. The special features of small issue IRBs may make them more or less effective in stimulating investment than other kinds of reductions in business taxes, but no strong evidence exists to support either possibility. The aggregate economic effects of eliminating small issue IRBs could thus be offset by a general business tax cut of the same size.

In the case of all tax measures aimed at stimulating investment, some of the resulting investment merely substitutes for investment that would have taken place in any event, while some may represent a net addition to overall investment. Overall increases in investment depend on overall increases in savings. Savings increases may result from the investment itself or from the tax subsidy that stimulate the investment. Increases in total savings and increases in investment may be simultaneous because of the increases in incomes that result from new investment. Firms that obtain financing for the construction of new plants, for example, hire architects and construction contractors and place orders for new equipment. The additional wages and profits that spring from these projects result in some increased savings.[8] Moreover, there are multiplier effects: the portion of increased wages and profits that is spent on goods and services represents new income for other workers and firms. The resulting increase in total income gives rise to more saving. In addition, the subsidy to investment represented by IRB financing implies an increased rate of return to savings, which may stimulate increases in households' rate of savings from current incomes.

If small issues were eliminated as of January 1, 1982, the reflow effects would be small in fiscal year 1982, but they would rise to $0.9 billion by fiscal year 1986, offsetting about 50 percent of the gross revenue gain (see Table 3).[9] The offset would gradually drop off after 1986 to about 40 percent. These estimates reflect the maximum reflows that could be expected. As set out in more detail in Appendix F, the assumptions used in making the estimates err in the direction of higher reflows.

In particular, the reflow estimates assume that a firm's desire to invest is highly responsive to changes in the cost of funds. Although investment is sensitive to the cost of capital,

8. This assumes some initial unemployment of labor and capital.

9. The figures do not include the small reflows in the form of higher spending that might occur on the outlay side of the budget.

TABLE 3. ESTIMATED REAVENUE GAINS FROM ELIMINATING SMALL ISSUE IRBS, FISCAL YEARS 1982-1986 (In billions of dollars)

	Gross Revenue Gain from Eliminating Small Issue IRBs[a]	Feedback	Net Revenue Gain from Eliminating IRBs
1982	0.1	0.1	0.0
1983	0.5	0.1	0.4
1984	0.9	0.3	0.6
1985	1.3	0.6	0.7
1986	1.6	0.8	0.8

SOURCE: Congressional Budget Office.

NOTE: A detailed explanation of the method used to calculate revenue feedback appears in Appendix F.

a. Effective January 1, 1982. Applies only to new issues after that date.

estimates of the degree of responsiveness vary. Second, and much more important, the procedure for estimating revenue feedback disregards the fact that the greater the supply of IRBs, the more the financing costs of other firms rise. To induce investors to buy additional IRBs, interest rates on IRBs (and other tax-exempt issues) must rise relative to the interest rates on alternative, taxable securities. As investors are attracted away from taxable securities to IRBs, the yield on the former must rise to restore their appeal.[10] These increases in the yield on other securities will raise the cost of funds to other firms, which in turn will reduce their investment spending. This offsets the net investment stimulus from IRBs, and thus reduces the revenue feedback associated with their elimination. CBO has not attempted to quantify these offsetting increases in the cost of capital because they are extremely hard to estimate.

EFFECTS ON STATE AND LOCAL TAX REVENUES

Since most small issue IRBs are exempt from state and local income taxes, they result in losses of state and local revenues. In some states, firms benefiting from IRBs are also exempt from local property taxes and from sales taxes on construction materials (see Chapter III). These are costs that state and local governments have voluntarily incurred, and they are usually considered necessary to attracting new businesses to a community, to persuading existing firms to remain, or to demonstrating favorable attitudes toward business. Most state and local government officials feel that IRBs are an important part of the package of investment incentives they have to offer.

To some extent, the emphasis that state and local officials place on incentives is of greater political than economic significance. Many private companies have lobbied for such incentives, and state legislatures have granted them. Their proliferation may well have less to do with demonstrable effectiveness than with the desire of local governments to create and preserve jobs. Regardless of IRBs' economic effectiveness, their availability is one manifestation of a desire to create a favorable environment for investment.

Small issue IRBs may appear to be less expensive than other state and local incentives to business, since the federal government bears the burden of the subsidy. The greater the sale of small issues, however, the greater the risk that the supply of tax-exempt bonds will grow in relation to the demand for them and

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10. For detailed discussions of these effects, see Galper and Toder, "Modelling the Effects of the Use of Tax-Exempt Bonds for Private Purposes," and Hendershott, "Mortgage Revenue Bonds: Tax Exemption With a Vengeance."

that the costs of local borrowing for traditional public purposes will rise. As a share of the market in long-term tax-exempt bonds, small issue IRB sales rose from 4 to 15 percent between 1975 and 1980.[11] (In 1975, the total volume of long-term tax-exempt bonds issued was $31.5 billion; in 1980, it was $53.3 billion.) Most students of tax-exempt bonds agree that an increased supply of them raises interest rates; but assessments of the effect of new revenue bond issues on tax-exempt interest rates vary widely.[12]

EFFECT ON THE DISTRIBUTION OF THE FEDERAL TAX BURDEN

Any increase in tax-exempt borrowing makes the federal tax structure less progressive. Purchasers of tax-exempt bonds are in relatively high marginal tax brackets. As the supply of tax-exempt issues increases, so do sales to higher-income purchasers. The result is an overall reduction in the tax liabilities of high-income purchasers.[13] The tax payments of lower-income persons, who get no benefit from holding tax-exempt securities, remain unchanged.

Tax-exempt bonds are attractive to potential purchasers if they offer a rate of return greater than the after-tax rate of return on taxable investments. Since tax-exempt interest rates usually are about 70 percent of taxable rates, investors with marginal tax rates below 30 percent realize higher after-tax returns with taxable investments. As an example, if investors could choose between a taxable bond with an interest rate of 10 percent and a comparable tax-exempt security at 7 percent, their responses would vary with their tax brackets. For an investor in

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11. These figures are based on data from the Daily Bond Buyer, adjusted to reflect unreported sales of small issue IRBs.

12. See Ronald Forbes, Phillip Fischer, and John Petersen, "The Remarkable Rise of the Municipal Revenue Bond" (unpublished paper, January 1980); John Petersen, "The Tax Exempt Pollution Control Bond" (unpublished paper); Peterson and Galper, "Tax Exempt Financing of Pollution Control;" Hendershott, "Mortgage Revenue Bonds."

13. High-income people do, however, pay an implicit tax equal to the interest differential.

the 20 percent bracket, the after-tax return on the taxable bond would be 8 percent, making it preferable to a tax-exempt security. Conversely, the after-tax return on the taxable bond is 6 percent for an investor in the 40 percent bracket; and it dips to a low point of 3 percent for an investor in the maximum bracket of 70 percent.

Thus, as the volume of tax-exempt issues grows, high income taxpayers are able to shield greater amounts of their income from taxation, increasingly undermining the progressive features of the system. If a less progressive tax structure is desired, the Congress could, of course, achieve it by lowering tax rates directly.

EFFECTS ON BUSINESS DECISIONS

The effects of small issue IRBs on investment decisions have been extensively surveyed. Most studies to date have concentrated on firm location, and their results have been inconclusive. The question breaks down into two parts. First, do small issues influence firm location? And second, how do they affect other investment decisions?

Firm Location. Some states have undertaken IRB programs in response either to actual or to perceived competition from other states. With virtually all states offering small issues, however, most such effects cancel each other out. Moreover, how much IRBs affected location decisions before the bonds became so widespread is an open question.

In general, manufacturing firms have significant latitude in selecting locations. Other kinds of enterprises--retail stores, restaurants, hotels--are more likely to locate wherever the markets for their products or services are best. Most of the literature on location concentrates on large manufacturing firms, and it suggests that proximity to markets, access to raw materials, labor and energy costs, and the availability of land are--altogether and sometimes one-by-one--the more important determinants of location.

Subsidized credit or state or local tax incentives usually play a lesser part.[14]

Most studies of the effects of IRBs on firms' location and investment decisions have been based on surveys of the behavior of relatively large national firms, and these have yielded conflicting results. A recent examination of these works indicated that the form of the question influenced the answers. Specifically, in responding to open-ended and nonspecific questions about the considerations influencing investment decisions, employers rarely mention IRBs or tax incentives. The few surveys that found these incentives important asked about them explicitly.[15]

To the extent that small issue IRBs may in fact affect location, they would influence the choice between two sites with nearly identical characteristics. These sites would most likely be within the same state or in bordering states. Competition between two localities can result if one of them cannot or will not issue IRBs, or if financial institutions in one area are offering clearly more favorable terms. IRBs seem to have little if any bearing on a firm's choice of general region, however.

These findings apply to relatively large industrial firms, which are a minority among the beneficiaries of IRB financing. Few studies have concentrated on the location decisions of small manufacturing firms. The little evidence available, though,

14. See especially Roger Vaughn, State Taxation and Economic Development (Washington, D.C.: Council of State Planning Agencies, 1979); Gary C. Cornia, William A. Testa, Frederick D. Stocker, State-Local Fiscal Incentives and Economic Development (Columbus, Ohio: Academy for Contemporary Problems, June 1978); Ralph Widner and Gary Cornia, "Interstate Tax Competition" (Unpublished paper, Academy for Contemporary Problems, November 1978); and Leonard Lund, "Factors in Corporate Locational Decisions," the Conference Board Information Bulletin, No. 66.

15. Margaret D. Dewar, "The Usefulness of Industrial Revenue Bond Programs for State Economic Development: Some Evidence from Massachusetts," Joint Center for Urban Studies of Harvard University and the Massachusetts Institute of Technology, Working Paper No. 63, March 1980.

suggests that such companies locate wherever their founding owners happen to live. One study, which concentrated on New England and part of Ohio, found that most new firms were spinoffs from existing firms in these areas and not establishments created by entrepreneurs from other places.[16]

Investment Decisions. Unlike location choices, investment decisions can be influenced by the now widespread availability of small issue IRBs.[17]

If the expected rate of return is the main determinant of a firm's investment decisions, then sales levels, availability of capital, and operating costs are likely to be primary considerations. Although operating costs may influence location, the decision to construct or expand facilities depends largely on demand, level of current output relative to productive capacity, and anticipated profits. As demand grows and facilities are used more intensively, firms are encouraged to expand, renovate, or replace plant and equipment.[18] Small issues have no direct effect on product demand or sales levels; they do, however, affect the availability and cost of long-term debt capital for projects that are eligible for the exemption.

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16. Roger Schmenner, "The Manufacturing Location Decision: Evidence from Cincinnati and New England" (U.S. Department of Commerce, Economic Development Research Report, 1978). Cited in Michael Kieschnick, Venture Capital and Urban Development (Washington, D.C., Council on State Planning Agencies, 1979), p. 28.

17. As discussed in more detail above, the effect of small issues on aggregate investment depends on how much they add to total savings; the effects discussed in this section represent mainly shifts of capital from one type of investment to another.

18. These issues are discussed in CBO, "An Evaluation of the President's Proposed Economic Development Administration Development Financing Programs," (July 1979). See also Dale W. Jorgenson, "Econometric Studies of Investment Behavior: A Survey," Journal of Economic Literature, vol. IX, no. 4 (December 1971).

Cost of Capital. From the standpoint of the individual firm, some projects might be impossible without small issue subsidies, while other efforts could go forward with conventional financing. The availability of small issue IRBs affects the cost of capital and therefore the amount and timing of investment. Some types of investment, such as real estate development, tend to be more responsive than others to interest rate subsidies.

Interest rate sensitivity may also vary with interest rate levels. Throughout 1979 and during the first several months of 1980, when interest rates were rising at record rates, the effect of IRB subsidies on investments may have been greater than had been the case before. The ratio between tax-exempt and taxable rates is as important as the rates themselves. In the past, the ratio of long-term tax-exempt rates to taxable interest rates has tended to be highest when interest rates were highest. The opposite was true in 1979 and early 1980, probably because inflation pushed taxpayers into higher brackets, and banks' demand for tax-exempt bonds to offset income tax liabilities was high. The effect was to make tax-exempt holdings relatively more attractive than taxable securities.

In general, small issue IRB financing is available only to creditworthy firms. Some states, however, make it possible for firms that have difficulty obtaining credit to benefit from IRBs by providing full or partial backing with state loan guarantees, mortgage insurance, or low-interest direct loans from state agencies. Although states could give similar support to conventional loans, lower interest rates might make more of a difference to these more marginal investments. A few states issue general obligation IRBs, which may either provide funds for individual projects or for umbrella loan pools. In these instances, small issues assist riskier businesses and, with other forms of financial aid, help bring about investment that would otherwise not take place. SBA loan guarantees have the same effect.

The influence of IRBs on investment decisions is more apparent for small firms than for large corporations. Although many large corporations are using IRBs, unless the users are investing in relatively low-cost facilities, they have to be concerned with the small issue capital expenditure limits. Smaller enterprises are in a better position to use IRBs and since such firms tend to operate with high debt-to-equity ratios, interest subsidies might be relatively more important in their investment decisions.

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EFFECTS ON FINANCIAL INSTITUTIONS

For commercial banks, the main purchasers of IRBs, the bonds have both benefits and drawbacks.

IRBs are hybrid obligations, with characteristics similar both to municipal securities and corporate loans. In most cases, either the mortgage or the commercial loan department of a bank will handle IRB transactions; investment and securities departments are less commonly involved in decisions on IRB loans. Nevertheless, since IRBs can sometimes qualify as investments, rather than loans, they enable banks to increase the amount of loan funds available when credit controls are in force. Moreover, small issues, unlike conventional loans, can often be used to meet requirements for public fund deposits. For a bank to hold deposits of public entities, it must hold some amount of public securities. For these purposes, IRBs can qualify as public securities.

Most banks view IRB transactions as loans. Although the banks are holding most bonds in their loan (and, occasionally, investment) portfolios and are receiving tax-free interest income, these investments are by and large no more liquid than mortgages or other loans. Unlike many other tax-exempt bonds, however, small issues are now usually written at a variable rate. If a bank wants tax-exempt income that is protected from interest rate fluctuations, small issue IRBs are one of the few sources for it. As variable rates become more common in the tax-exempt bond market in general, however, the demand for small issues might diminish. Similarly, any changes in federal banking or securities regulations concerning the treatment of small issues could have substantial effects on the demand for them.

CHAPTER V. POLICY ALTERNATIVES

The mushrooming use of tax-exempt IRBs to subsidize private development raises a number of policy issues. First, should the federal government intervene at all in the use of small issues? Before 1968, the federal government had left the use of IRBs up to the states. Since then, the federal government has defined permissible and impermissible uses.[1] Whether these definitions should remain or be changed depends on Congressional perceptions of the public policy objectives involved. To some extent, the decision may also turn on estimates of the likely future volume of IRBs if current law is maintained.

A few years ago, the reported volume of small issues was considerably less than $1 billion a year and the possibility that the market might be much larger drew little attention. In 1980, sales exceeded $8 billion. During the first half of the 1980s, sales could grow at a fairly slow but steady pace, or, if financial institutions develop means to broaden the market for these bonds, sales could boom as they did in the late 1970s (see Chapter IV).

In light of new information on the growth of the small issue market, the Congress may wish to consider several questions: What purposes are served by providing federal subsidies to lower the borrowing costs of private industry? How effective are small issue IRBs in meeting these objectives? Should the availability of IRBs be increased? If so, why? How could the availability of small issue IRBs best be increased? What would be the effect? What would be the consequences of maintaining current law? Should the federal government require that better data be kept on the uses and volume of small issues? Should the availability of small issues be restricted? If so, how and for what purposes?

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1. The Revenue Expenditure and Control Act of 1968 (discussed in Chapter II).

POLICY GOALS AND THE EFFECTIVENESS OF SMALL ISSUES

Subsidized credit can achieve a number of goals. Depending on the extent of its availability, it can stimulate investment and capital formation, increase employment, modify the market's allocation of credit, and serve as a development tool in selected areas. Small issues could serve all these objectives to some extent, but in many cases their effectiveness is limited. For example:

- o If the aim of federal interest subsidies is to stimulate investment, a general business tax cut might be equally if not more effective. Since the Economic Recovery Act of 1981 lowered business taxes, the Congress may want to weigh the costs of small issues against the benefits of recent cuts.

- o If the purpose of subsidies is to alter the market's allocation of capital so that smaller firms have access to credit on more favorable terms, the Congress might want to consider modifying current law to make small issue IRBs a more effective tool. To date, small issues have to some extent stimulated additional investment among smaller firms. They do not, however, make low-cost credit available to firms that have difficulty qualifying for conventional financing. Nor are they restricted to smaller firms. Under the right conditions, large corporations can realize significant benefits from small issues.

- o Finally, if the objective is to use subsidies to stimulate development in economically distressed areas, the Congress may want to consider ways to target IRBs to specific locations and to coordinate use of the bonds not only with UDAG, but with other federal credit programs, such as EDA, SBA and FmHA loans, grants and guarantees (see Chapter III).

POLICY ALTERNATIVES

Depending on the Congress' objectives, the range of possible legislative action is wide. The Congress could remove all restrictions on small issues, or it could do away with the bonds entirely. Between these extremes are several other options. These include maintaining current law or modifying it either by making it more lenient or by restricting the volume of small issues, their purposes, or both. The choice among these alternatives depends upon the Congress' perception of the public interest and the proper reaches of federal authority.

EASE RESTRICTIONS

Remove All Limits on IRBs

The Congress may maintain the position that the states are in the best position to determine the public interest with respect to the bonds they issue and that the federal government should place no limits on small issues. The bond issues of state and local governments have been exempt from federal taxation ever since the passage of the income tax amendment in 1913; IRBs are an exception. Under the Revenue Expenditure and Control Act of 1968, IRBs are subject to federal taxation unless they are for specified purposes, such as pollution control facilities, or are for amounts that fall within specified capital expenditure limits.

The theory behind subjecting IRBs to federal taxation is that their proceeds flow to non-public enterprises and finance non-public activities. Although this theory has never been challenged in the courts, the decisions of local government to provide assistance to certain industries might be considered integral functions of government that the Congress cannot regulate without infringing on state sovereignty.[2]

The counterargument is that, since IRBs provide financing for private enterprises rather than for public facilities, and since the income from IRBs is exempt from federal taxation, the federal government has every right to determine their public purpose. At present, federal legislation specifies exempt activities for some IRBs and sets capital expenditure limits for others. Within these limits, the states can define public purpose, since federal law contains no other guidelines. The states, in turn, have evolved a wide variety of practices. At one extreme are laws permitting IRB financing for any legal business regardless of where it is located

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2. See, for example, John J. Keohane, "The Mortgage Subsidy Bond Tax Act of 1979: An Unwarranted Attack on State Sovereignty," The Fordham Urban Law Journal, pp. 483-505.

or how many jobs it creates. At the other are the few laws prohibiting use of IRBs. The only way the Congress could bring about greater uniformity among the states would be to modify current law by more clearly specifying its policy objectives.

A second argument against removing all limits on IRBs is that the bonds would then be able to finance any facility regardless of cost. This would reverse the policy set forth in 1968, which was intended to restrict large corporations from using the bonds. Tax-exempt financing would skyrocket, sharply increasing the costs of both municipal and other borrowing. The effects on business investment might be beneficial, but the flow of resources to other forms of investment would decrease, with possible adverse consequences to the economy as a whole. Moreover, as more and more tax-exempt issues came to the market, the difference between taxable and tax-exempt interest rates would narrow, eventually wiping out most of the benefits of the subsidy. This could have a serious adverse effect on state and local governments, which would have to pay much higher interest rates on their borrowing.

If the aim of the Congress is simply to increase business investment and capital formation, it could do so with a general business tax cut without having the same adverse impact on state and local borrowing. As discussed in Chapter IV, the overall economic effects of increased IRB financing are not significantly different from those of a general business tax cut with the same revenue loss.

Raise the Capital Expenditure Limits on IRBs

The current capital expenditure limits on IRBs have not kept up with inflation. In 1968, the Congress passed legislation permitting up to $1 million of small issue financing for any facility and up to $5 million if expenditures on a facility did not exceed that amount over a six-year period. The $1 million limit is still in effect. Legislation passed in 1978 raised the $5 million limit to $10 million. If, however, both limits had kept pace with inflation, they would have risen to $2.1 million and $10.5 million, respectively, by mid-1981.

Although inflation has eroded the value of the current limits, whether or not the Congress decides to raise them depends on its policy objectives. If the purpose of current law is to assist smaller firms, no increase is necessary. In 1980, the overwhelming number of financings--94 percent--was for less than $5 million. These projects represented 34 percent of the dollar volume of IRB sales. More than 64 percent of the number of projects was for less than $1 million. The average project financing in 1980 was $1.3 million, down from $1.4 million in 1979. These data suggest that, for most projects, the current capital expenditure limits pose no problems.

The present limits operate to the disadvantage of larger firms. Even so, some large firms have benefited from tax-exempt financing. If the $10 million capital expenditure limit were raised, a much larger number of projects would be eligible for tax-exempt financing. As a result, small issue sales and revenue losses would increase. Since small issues would then also represent a larger share of both tax-exempt financing and long-term corporate borrowing, their effects on tax-exempt and conventional interest rates would be greater. At present, most small issues are unrated obligations, with little if any liquidity. Since the market for them is limited, the banks usually hold on to these securities until they mature. If the limits are raised, many more of the small issues that come to market will be rated issues of large corporations. These could have a marked effect on capital markets and on the cost of municipal borrowing. They might also squeeze out some of the unrated issues of smaller firms.

An increase in the $1 million limit would raise the number of projects that large corporations could finance with tax-exempt funds without regard to the total capital expenditures on the facility. In practice, it would mean that the financings--generally for equipment purchases--that currently are exactly $1 million would increase to the new level. At present, large companies often float $1 million bond issues at the same time that they float bonds for pollution control. If the limit were higher, the incentive to float bonds independent of any other financing would probably increase.

Based on past experience, CBO estimates that an increase in the so-called "clean" $1 million limit to $3 million, and in the capital expenditure limit from $10 million to $15 million, would result in sales of $20 billion in 1982 and would cost the federal government $1.6 billion in foregone tax revenues in fiscal year 1982. If only the capital expenditure limit were raised, sales in 1982 would increase to $16 billion, rising to between $23 billion and $58 billion by 1986. The resulting costs would amount to $1.5 billion in fiscal year 1982, rising to between $3.8 billion and $5.0 billion by fiscal year 1986.

MAINTAIN CURRENT LAW

If the Congress decides to take no action, the states will continue to determine the public purpose of small issue IRBs with widely differing results. Some states will continue to take maximum advantage of federal law, while others will define public purpose more narrowly. A minority of states and localities will try to integrate the use of small issues with other development efforts; but in most cases, IRB sales will continue to have no relationship to state or local planning processes.

The Congress may decide that, regardless of (or maybe because of) their differences, state and local governments are in the best position to determine the public interest. The problem with this position is that the federal government bears the largest share of the cost of small issues and therefore has the greatest stake in regulating their use. Moreover, while some state officials might resent regulation, others might find it helpful in resisting the mounting pressure to expand the uses of small issue IRBs without regard to public purpose.

Even where the motivation exists, the pressures in many states work against restricting the use of small issues. Many if not most local officials believe that the states compete for new investment. A competitive climate among the states makes it less likely that states will voluntarily curb investment incentives for private industry, particularly if the benefits are financed primarily with federal funds. Moreover, in issuing tax-exempt bonds for private business, many local agencies are acting as financial intermediaries and are receiving fees for their services. Where these fees support state and local agencies, the impulse to curb activity may be weak.

Maintain Current Law, but Require Reporting of IRB Sales. Even if it makes no changes in current law, the Congress may want to be apprised of the annual volume of small issue sales so that it may more accurately estimate the costs of continuing tax exemption. At present, no mechanism exists for reporting IRB sales to any federal agency. The Congress could rectify the situation by making tax exemption conditional on the reporting of sales.[3]

To prevent any single federal agency from being inundated with reports from myriad localities, the Congress may want to require that by a specified date each state submit an annual report on small issues. The states would have to impose similar requirements on the bond issuing agencies within their jurisdictions.

TIGHTEN RESTRICTIONS

The federal government could take action to reduce the volume of small issues, to restrict the uses of the bonds' proceeds, or both. The means of accomplishing these objectives could be through the establishment of more stringent federal guidelines or through legislation that places the burden of setting limits on the states.

The federal government could directly limit the purposes of the bonds by restricting tax exemption to certain eligible businesses or activities. For example, the Congress could restrict tax exemption to small issues that are targeted toward small businesses, firms in distressed areas, industrial firms, or all of these. Federal limits on the purposes of the bonds would presumably reduce current volume and future growth.

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3. In order to have a basis for future evaluations of small issues, it would be necessary for reports to provide the following information for each bond issue: Issuing jurisdiction and agency; name and address of the beneficiary firm; the type of business; the amount, term and interest rate of the bond or loan; the underwriter (if any); the purchaser of the bonds; the size of firm (by assets and previous year's sales); the number of employees in the firm; the estimated number of new jobs generated by the project; the age of the firm; and whether the purpose of the funds was to open a new business, to build a new branch plant, to expand an existing facility, or simply to acquire an existing business. In addition, it would be useful to know the number and dollar volume of IRBs that are backed by the credit of the state through general obligation funding or state guarantees and the number and volume of sales associated with UDAG projects. While virtually no state agencies currently have such detailed information on their bond issues, a few, such as New York and Wisconsin, come close.

An alternative approach, which would leave the decision on the purposes of the bonds to states and localities, would be to impose state-by-state caps on the annual volume of small issue IRBs or to require some commitment by state and local governments that would assure more careful review of the uses of the bonds. State and local governments might be required to back IRBs with their own full faith and credit, for example, or with matching state or local funds or other incentives. Such an approach would leave the decision of public purpose in state and local hands and at the same time preserve the federal interest in limiting the overall volume of the bonds.

Target IRBs to Smaller Businesses

The expenditure limits on small issues prevent firms from using more than $1 million of tax-exempt financing on facilities that will require investments of more than $10 million over a six-year period. As a result, small and medium-sized firms are apt to make wider use of IRBs. Nothing in the legislation, however, prevents large corporations from using many times $10 million a year in IRB financing to build branch facilities across the country, as long as the cost of each facility falls within the capital expenditure limits. Consequently, small issues have been a boon to national retail firms, which require relatively little expenditure for capital equipment.

The Congress may determine that small issues should be targeted to smaller businesses. If so, it may establish criteria for small businesses that conform to those set forth by the SBA, or it could establish more stringent criteria on the grounds that SBA definitions include 95 percent of all of the firms in the country. It could, for example, limit assistance based on a firm's capital assets. Banks and other investors, bond counsel and issuing agencies would have to assure themselves that a firm met the criteria, just as they now have to assure that firm expenditures on a facility are within the capital expenditure limits.

Alternatively, the Congress could sharply limit the usefulness of small issues to larger firms by setting a limit of, say, $10 million on the amount of tax-exempt financing that any firm could use in a year, or for a lifetime. In tandem with the present capital expenditure limits, this would prevent most large corporations from using IRBs and from financing national expansion programs with them. Of the many possible changes in current law,